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Western Europe: Attitudes Toward Welfare and Defense Spending

Summary

The West European welfare state is in crisis. Demands for state services and payments are rising rapidly while revenues are failing to keep up. In France and Italy, Socialist-led governments are attempting at least to restrain the further growth of social welfare spending. Conservative and Christian Democratic governments in the United Kingdom, West Germany, Belgium, the Netherlands, and Denmark are committed to trimming welfare benefits and reducing the state's social and economic role. The heavy welfare burden has already forced reductions of the modest increases in military budgets agreed by NATO, and most governments intend to make further cuts in planned increases in defense spending. [redacted] 25X1

Public pressures limit the ability of governments to cut back social welfare programs, especially in the absence of even deeper cuts in defense. [redacted] 25X1

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[redacted] While some prefer to see the fiscal policy dilemma solved by government borrowing, most oppose higher taxes or cuts in social welfare programs and prefer reductions in defense spending. [redacted] 25X1

We expect governments to opt for a combination of these approaches. Because social programs consume a large proportion of public budgets, austerity limited to other areas would be unlikely to solve governments' fiscal problems. Economically necessary welfare cutbacks, however, could politically weaken northern Europe's fiscally conservative governments, particularly in the face of high unemployment and sluggish economic growth. [redacted] 25X1

The need to trim welfare spending will prevent significant military spending increases in most West European countries, in our judgment. Because their publics consider defense costs the major cause of deficits, governments will be unlikely to promote defense increases while cutting back in other areas. Most West European governments are unlikely even to approach NATO's target of 3-percent real military spending increases in the next few years, and in some countries real military spending may actually decrease. As a result, planned equipment modernization programs are likely to be delayed or cancelled, and overall military capabilities may decline. [redacted] 25X1

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Pressures on the Welfare State

The West European welfare state has become far more than a social safety net assuring basic needs. Although the welfare state began by supplementing emergency assistance to the destitute with social insurance for industrial workers, it now also provides wide-ranging benefits to the middle and upper classes. Numerous universal health care programs, family allowances, student grants, and old age, invalidity, and sickness insurance schemes attempt to assure a rough continuity of income for virtually all citizens. [redacted] 25X1

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West European governments use a variety of instruments to promote economic security and equality. The broadest definition of the welfare state includes active fiscal, monetary, and exchange rate policies aimed at economic growth and full employment, as well as the investment and hiring decisions of state-owned firms--which play a major role in West European economies. More narrowly, the welfare state comprises a wide range of cash payments and services-in-kind provided by the government. Transfer payments, financed either through earmarked taxes or general revenues, assure income maintenance for periods of unemployment caused by maternity, childhood, education, old age, sickness, disability, and job loss. Services-in-kind not available to all citizens on the free market include education, health care, social counseling, and housing. (See Table 1).* 25X1

Social Policy Dilemmas

In recent years, the costs of welfare programs have soared while state revenues have grown only modestly. According to the European Community, social welfare expenditures consumed an average of 27 percent of gross domestic product in EC countries in 1981, compared with 19 percent in 1970. (See Figure 1) An EC publication recently estimated that higher outlays for social benefits accounted for about one-half of the total rise in member governments' budgets between 1973 and 1982. 25X1

Since the oil crisis of 1973-74, slow economic growth, high unemployment, and aging populations have simultaneously decreased the government's tax base and required higher social spending.

-- Slow economic growth is reducing the growth of revenues from business and personal taxes as well as employers' and employees' social security contributions.

-- High jobless rates mean both a fall in tax revenues and soaring unemployment compensation costs.

-- Aging populations require added expenditures both for pensions and for health. While the percentage of the population over 65 is beginning to stabilize after a sizable increase in the 1970s, those over 75--who are

* For a detailed breakdown of social benefits in each country, see Social Security Programs Throughout the World, U.S. Department of Health and Human Services, SSA Publication No. 13-11805. 25X1

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Table 1

The West European welfare state utilizes a mix of cash payments and services-in-kind, supplemented by government decisions on tax credits, price subsidies, and the behavior of state-owned enterprises. West European governments administer wide-ranging health services, housing, family allowances, old-age and disability pensions, and unemployment benefits. Funding methods vary widely among the countries and the specific programs, but inevitably involve a major element of state subsidy. 25X1

The following table shows the relative costs to governments of the major social programs.

Specific Benefits by Type, 1980
(percent of total social spending)

	BELG	DK	FRG	FR	ITY	NL	UK
Sickness	22	27	30	26	23	29	22
Invalidity-disability	8	9	6	5	20	20	9
Employment injury-occupational diseases	3	1	3	4	3		1
Old age	26	35	26	35	34	28	40
Survivors	12	1	15	7	10	5	2
Maternity	1	1	1	2	1	0	2
Family	12	10	8	13	7	9	11
Vocational guidance-mobility	2	1	3	0	0	-	0
Unemployment	10	12	4	7	2	6	9
Housing	-	1	1	-	0	1	1
Miscellaneous	3	3	4	1	0	1	2

Source: European Community

Columns may not add to 100 because of rounding.

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Figure 1

General Government Spending As a Percentage of GDP

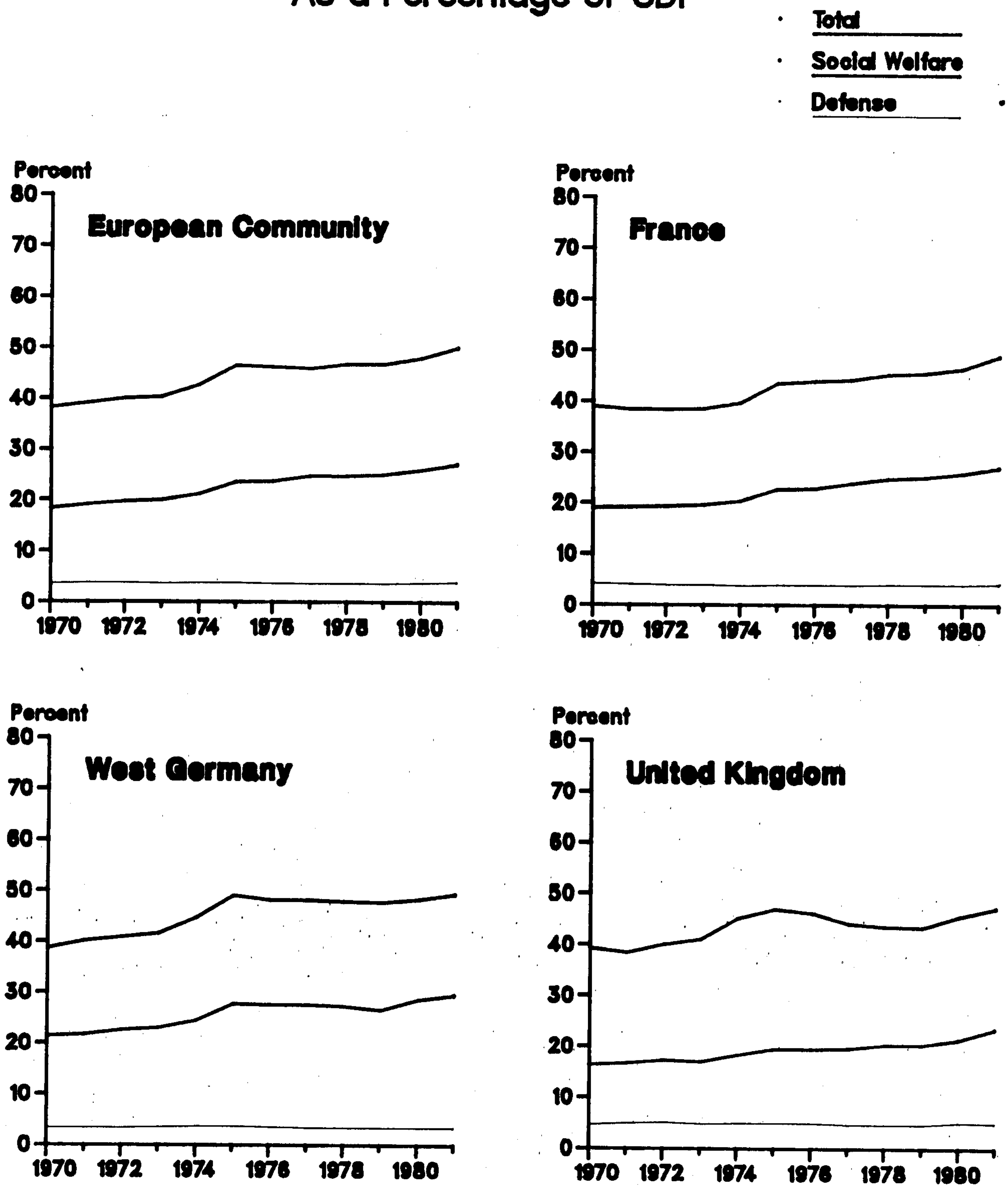

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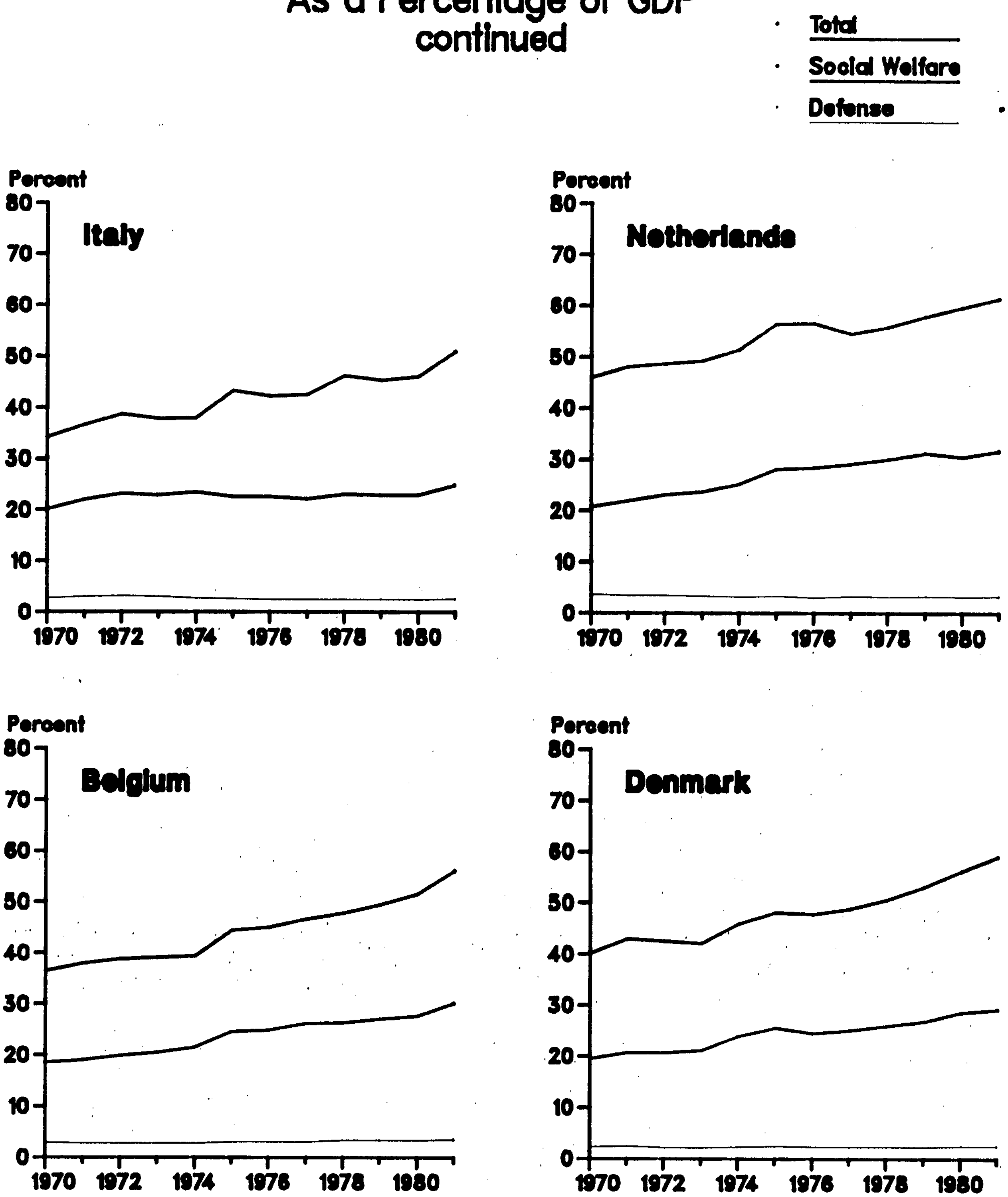
Figure 1
(cont'd)

General Government Spending As a Percentage of GDP continued



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the most likely to become ill--are increasing in number in many West European countries. In addition, since the mid-1970s many West European governments are encouraging early retirement in order to create new jobs, which is requiring still higher expenditures on pensions. [redacted] 25X1

In some ways, the welfare state is as much the cause as the victim of Western Europe's macroeconomic difficulties. Recent academic studies point out that large employers' taxes for unemployment, health, and disability insurance create a "wage gap" between workers' take-home salaries and their total cost to firms. By making labor more expensive to employers, the non-wage payments reduce the demand for labor and encourage automation. They also reduce business profits available for new investment. (See Table 2). In addition, by promoting the right to employment--in some cases in the industry and location of the worker's preference--governments have subsidized both capital and labor in low-productivity uses, thereby contributing to slower growth. [redacted] 25X1

We expect the strains on social welfare budgets to continue throughout the 1980's even if, as expected, moderate economic growth continues in Western Europe. According to private and official forecasts and our own analysis, Western Europe's already high unemployment rates are likely to increase still more in the next several years, primarily because demographic trends will add even more prospective workers to the labor force than in the 1970s and because wage costs almost certainly will not moderate sufficiently to create enough new jobs. In addition, most economists expect the recovery in Western Europe to be much less robust than those following previous recessions, which means that job creation will be slower and that government tax revenues will increase less rapidly than during past recoveries.* Furthermore, the costs of health care and old-age pensions will grow as the numbers of the elderly and retired persons increase. [redacted] 25X1

Government Responses So Far

The soaring costs of social welfare programs are forcing governments to question the assumptions of universal protection and continual growth of benefits that have underlain the postwar welfare state. All of the West European governments are trimming benefits in order at least to slow the rise of social spending (see Table 3). Although high unemployment and expanding retired populations will require continued increases in total outlays,

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Table 2

Western Europe: Non-Wage Costs as a Share of Direct Wages 1970-1982

	1970	1975	1980	1981	1982
West Germany	42.1	56.1	68.3	70.6	72.6
France	59.0	69.1	76.6	77.8	83.8
Italy	77.7	97.5	87.6	84.4	86.1
United Kingdom	14.6	23.4	33.9	35.8	35.8

Table 3

National Austerity Programs

West Germany

Governing parties:	Christian Democratic Union, Christian Social Union, Free Democratic Party
Last parliamentary election:	March 1983
Austerity Program:	The Kohl government has intensified efforts to limit spending begun by its Social Democratic-Free Democratic predecessor. In December 1982, Kohl announced cuts in family allowances, changed student grants to loans, delayed pension increases by six months, reduced some subsidies to industry and agriculture, and decreased the state share of unemployment insurance and pension contributions. He now is pressing for cuts in unemployment benefits and a pay freeze for civil servants not covered by collective bargaining.

France

Governing Parties:	Socialists, Communists
Last presidential election	May 1981
Austerity program:	The French austerity program has concentrated on increasing revenues but is also cutting some social benefits. Shortly after assuming power, the Socialist-dominated government increased family allowances and rent allowances for the poor, reduced the retirement age, shortened the statutory work week, and introduced a fifth week of paid vacation. By 1983, however, Mitterrand was forced to cut the government budget deficit in order to restrain domestic demand, fight inflation, and reduce France's current account deficit. On 25 March, the government announced new taxes on income, gas, electricity, telephones, gasoline, and alcohol. It also introduced a daily fee for stays in state-run hospitals. In addition, Mitterrand has slowed the growth of transfer payments such as family allowances, income support, and aid for the aged and the handicapped.

United Kingdom

Governing party:	Conservatives
Last parliamentary election:	June 1983
Austerity Program:	Prime Minister Thatcher has systematically attempted to reduce the state's overall economic role, primarily by limiting total spending and public borrowing. Until now, social spending has not been the prime target for budget cuts, in part because transfer payments have been needed to cushion the results of recession. At present, however, the government is considering a variety of cuts in unemployment compensation and other benefits.

Italy

Governing parties:	Socialists, Christian Democrats, Liberals, Republicans, Social Democrats
Last parliamentary election:	June 1983
Austerity Program:	Italian efforts to reduce the burgeoning state deficit have concentrated on raising taxes, but the new Socialist-led government is also committed to limiting social spending. Prime Minister Craxi is proposing higher charges for health-care, an increase in the retirement age, and measures to right abuses of Italy's generous disability pension program. Prospects for implementing austerity, however, remain uncertain.

Belgium

Governing parties:	Flemish and Walloon Social Christians, Flemish and Walloon Liberals
Last parliamentary election:	November 1981 (government formed in December 1981)
Austerity Program:	Prime Minister Martens' center-right government in Belgium instituted a "crisis" austerity program in February 1982. It concentrated on cutting real wages in both the public and the private sectors in order to hold down deficits in the budget and the current account. In addition, however, the government has cut spending on social security and education. For 1984, the government is proposing cuts in expected pension

increases, hikes in employers' and employees' social security contributions, and reductions in unemployment benefits.

The Netherlands

Governing parties: Christian Democrats, Liberals

Last parliamentary election: September 1982 (government formed in December 1982)

Austerity Program: Dutch efforts to cut budget deficits focus on expenditures rather than revenues, since taxes already devour over 60 percent of the Netherlands' national income. In 1983, Prime Minister Lubbers' center-right governnment froze social security benefits, trimmed several welfare programs, and reduced the government share of pension contributions. In April, the government announced cuts in disability pensions and in government subsidies to social programs as well as a 2 per cent reduction in all social benefits effective on 1 October.

Denmark

Governing parties: Conservatives, Center Democrats, Liberals, Christian People's Party

Last parliamentary elections: September 1982

Austerity Program: Danish Prime Minister Schlueter's center-right coalition has introduced wideranging measures to cut back welfare spending while avoiding higher taxes. In October 1982, it announced tighter criteria for unemployment compensation and public assistance, reductions in government subsidies to non-profit housing, increased user contributions for numerous public services, and limitations on cost-of-living adjustments in transfer payments and pensions. In September 1983, Schlueter secured Parliament's approval for cuts in subsidies to local governments, which administer roads, hospitals, and schools.

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for the first time governments are systematically attempting to reduce real transfers and services available to individuals. [redacted] 25X1

Certain governments are also challenging basic premises of the postwar welfare state. Although the Socialist-led governments in France and Italy are justifying ad hoc cuts as emergency measures to contain runaway budget deficits, the governments of West Germany, the United Kingdom, and Denmark are questioning the principle of universal benefits. Leaders of the fiscally conservative governments in these countries contend that the state should provide a social safety net for severe emergencies but that it should stop trying to guarantee full income maintenance in all contingencies. Instead, they argue, individuals should assume greater responsibility for their own well-being. Consequently, these governments are introducing income tests and user fees for a variety of social services. [redacted] 25X1

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So far, northern Europe's fiscally conservative governments have been able to enact welfare cutbacks despite resistance from opposition parties. Except in Denmark, the governing coalitions enjoy solid parliamentary majorities. Socialist opposition parties are attempting to exploit public hostility to cutbacks, but have offered no clear alternatives for reducing budget deficits. In addition, socialist and social democratic parties in West Germany, Denmark, Belgium, and the Netherlands still labor under public disenchantment with their recent economic performance while in power. [redacted] 25X1

The French and Italian socialist-led governments face less organized political opposition to austerity. In France, the opposition parties are attacking the recent tax increases, but the Communists--who normally would be the strongest foes of welfare cuts--are restrained from being too vocal in their criticism by their participation in the cabinet. In Italy, all five coalition parties have endorsed austerity in principle, but many of their deputies in Parliament are objecting to specific welfare cutbacks. [redacted] 25X1

The broad public support for most social welfare programs makes governments reluctant to go too far. Most are also attempting to limit their budget deficits by taking a more parsimonious approach to defense spending despite the fact that it accounts for a far smaller percentage of their countries budgets. [redacted] 25X1

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Public Opinion and the Welfare State

Although economic necessity has forced most West European governments to begin trimming welfare benefits, the extent of future cutbacks will depend in part on public views of current spending levels and budgetary choices. [redacted] 25X1

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West European publics strongly support an active state role in the economy. [redacted] 25X1

[redacted] 25X1

Large majorities of European publics oppose reductions in social spending. In most cases, even high-income respondents and right-of-center voters tend to reject welfare reductions.

-- In a French poll published in July, 58 percent said the health budget must cover health needs regardless of how national wealth changes.

-- In a Dutch poll conducted in April, two-thirds of the respondents opposed any reductions in social benefits.

-- In a British poll in July, two-thirds said that spending on education, old-age pensions, and the National Health Service is too low. [redacted] 25X1

European publics distinguish sharply, however, among the various types of social benefits. A 1980 study of public opinion

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on welfare policy that included five West European countries noted virtually universal support for old-age pensions and state-run health care. Both programs insure the entire population in most of Western Europe; in addition, pensions--and in some countries health services--are entitlements financed by earmarked personal contributions. Public attitudes are much more ambiguous, however, toward programs that affect only a fraction of the population, such as family allowances, unemployment compensation, and public assistance to the destitute. [redacted] 25X1

In contrast, West European publics are not supportive of military spending. [redacted] 25X1 25X1 A USIA poll in April 1982 found pluralities opposed to defense spending increases in 25X1 France, West Germany, Italy, and the Netherlands. A plurality of Britons favored increases, probably in reaction to the Falklands conflict. (See Table 5). In a July 1983 Gallup survey, however, almost half of the Britons polled said defense spending is too high while only 12 percent said it is too low. [redacted] 25X1

<u>Paying for the Welfare State: "Guns vs Butter"</u>

While supporting social benefits, West Europeans are less 25X1 enamored of big government. [redacted] 25X1

High taxes are the prime source of discontent with government. Current receipts of government, which consumed less than 30 percent of GDP in the EC countries in 1961, averaged over 44 percent in 1981--the most recent year for which the OECD has compiled statistics. According to numerous academic studies, Western Europe's sharply progressive income taxes are a major disincentive to additional personal economic effort, while rapidly rising business taxes are siphoning funds away from private investment. [redacted] 25X1

Public attitudes toward state spending reflect the composition as much as the level of taxation, according to several academic studies. Polls show little opposition to social security contributions and business levies. More visible taxes not linked to specific benefits, such as income and sales taxes, generally provoke the greatest public discontent. The studies note that Denmark, which relied much more on income taxes and much less on social security contributions than did its EC

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Table 5

Attitudes Toward Defense Spending
(percent)

(April 1982)

	United Kingdom	France	West Germany	Italy	Netherlands
Increase	44	16	15	16	11
Decrease	16	24	26	46	36
Keep at Present Level	36	55	43	34	35
Don't know	4	5	16	4	17

Source: USIA

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partners, experienced the first widespread tax revolt in Western Europe in the early 1970's. Holland, whose taxes consume about the same percentage of GDP but are more evenly based, has witnessed no comparable phenomenon. [redacted] 25X1

Further tax increases are even more unpopular than social spending cuts in most West European countries for which polling data are available. [redacted] 25X1 25X1

In British Gallup surveys 25X1 conducted from 1979 through 1983, [redacted] about half of the 25X1 respondents favored increased social welfare programs even at the cost of higher taxes--a sentiment reflecting, in our view, widespread dissatisfaction with Prime Minister Thatcher's economic policies. The British results may also reflect the UK's high share of business taxes and low share of social security contributions as compared to EC averages. [redacted] 25X1

Prospects for Retrenchment

Despite the political risks of cutting welfare, we believe West European governments have no other economic choice. To be sure, raising taxes and reducing non-welfare spending can help to hold down budget deficits. But social programs consume such a large share of public budgets that austerity limited to other areas would be unlikely to solve governments' financial problems. Nor is unrestrained big spending a likely policy alternative, in our judgment. Although deficit financing poses few immediate political risks to governments, it threatens their overall economic goals. Financing deficits by means of faster monetary growth can fuel inflation, while borrowing in capital markets can raise interest rates and thus hamper economic growth. [redacted] 25X1

Most West European governments will probably seek to limit defense spending, public sector wages, and other non-welfare budget items. For all the West European governments, however, even cancelling all planned military spending increases would eliminate only a small fraction of the deficit. Holding down civil servants' salaries could result in greater savings but provokes greater opposition, as shown by recent public sector strikes in the Netherlands and Belgium. [redacted] 25X1

Some governments will probably try to raise new revenues. The French, for example, have already increased user charges for a variety of public services. Taxes, however, are already so high in most West European countries that substantial further

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increases could impede economic growth and provoke stiff political resistance. [redacted] 25X1

We believe that West European governments will thus be forced to continue trimming welfare benefits. Because of growing numbers of pensioners and continuing high unemployment, cuts will probably be insufficient to reverse the overall growth in welfare budgets, but they should be able to slow the rise in social spending. Even conservative governments are unlikely to challenge basic structures of the welfare state, since this would undermine support for more modest measures of austerity. [redacted] 25X1

In making these cuts, most governments in our view will emphasize the welfare state's function as a social safety net and chip away at the practice of universal coverage. West Germany, the United Kingdom, Denmark, Belgium, and the Netherlands will probably tighten eligibility requirements for many social benefits. These countries are also likely to limit cost-of-living adjustments in income transfers and make greater use of means tests for public assistance. [redacted] 25X1

To be sure, slower than anticipated economic growth would hold down tax revenues and force greater welfare cutbacks than we foresee. In this case, governments may be forced to make deep cuts in parts of the social safety net, such as family allowances, unemployment compensation, and public assistance. While crucially important to specific groups, these programs are 25X1 less popular among the general public than are universal benefits such as health care and old-age pensions, according to numerous [redacted] academic studies. [redacted] 25X1

Governments will probably be careful to present welfare reductions as the least of several evils. By portraying cuts as the alternative to highly unpopular new taxes or still higher deficits, they may obtain at least grudging majority acceptance of some austerity. By stressing overall limits on welfare budgets rather than specific cutbacks, governments can also appeal to the large minorities who say social spending is too high already. Given their emphasis on overall austerity, most West European governments are unlikely to risk a public furor by significantly increasing military budgets at a time of welfare cutbacks. [redacted] 25X1

Political Implications of Austerity

Governments clearly face political risks in proposing welfare cutbacks. With unemployment rates expected to remain high for the remainder of the decade, publics will probably be increasingly critical of governments' overall economic record. Modest economic growth may help shore up governments' popularity

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and facilitate acceptance of limited austerity. Ironically, however, a robust recovery could fuel public opposition to welfare cuts by increasing tax revenues and fostering the perception that retrenchment is no longer necessary. [redacted] 25X1

Much of the population would react to future cuts in welfare, [redacted] 25X1

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Recent trade union and voter behavior does show some tolerance for spending cuts, although it is not clear whether this is a temporary phenomenon. Organized labor--usually an ardent foe of government austerity--has been remarkably quiescent in the face of the social spending cuts of the last few years. Unions in most West European countries have frequently denounced austerity, but strike action has been minimal.

-- The major exception was widespread public service strikes in Belgium and the Netherlands this autumn, which protested salary reductions rather than cutbacks in social welfare.

-- West German unions have demonstrated against cutbacks in pensions and unemployment benefits, but are prohibited by law from striking except in connection with collective bargaining.

-- In France, the head of the pro-socialist union confederation pointed to the need for austerity last January, and pro-communist unionists have been constrained from protesting Mitterrand's policies too vigorously by the Communist Party's participation in the government.

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Unions may become more militant if an unexpectedly strong economic upturn decreases unemployment, but their overall decline in strength and influence nonetheless has somewhat weakened their bargaining position. [redacted] 25X1

Recent elections in northern Europe also suggest that voters are prepared to accept some retrenchment in social programs, particularly when they are dissatisfied by the economic record of socialist-led governments. During the past 18 months, voters in the United Kingdom, West Germany, Denmark, Belgium, and the Netherlands have elected or re-elected administrations pledged to containing social welfare spending. The Conservative and Christian Democratic victories in northern Europe do not, of course, result from a public clamor for welfare cuts, and austerity could help erode support for governments if they fail to deal effectively with inflation, unemployment, foreign trade deficits, and slow economic growth. [redacted] 25X1

Impact on the United States

In our judgment, the continuing need to trim social welfare spending will prevent significant military spending increases in most West European countries, and could even lead to selective cutbacks. Although defense expenditures account for only a small proportion of West European public budgets, most governments are sensitive to the linkage between defense and social welfare spending in the public mind. They will thus be loath to promote defense increases while being parsimonious in other areas. Even Prime Minister Thatcher, who enjoys a solid Parliamentary majority and does not need to call elections before 1988, is facing growing difficulties in maintaining planned increases in the military budget. Most other West European governments, which have had an uneven record of meeting NATO's target of a 3 percent real yearly increase in defense spending, are unlikely even to approach that goal in the next several years. If NATO continues to insist on the 3-percent target, many governments may increasingly manipulate budget figures to feign compliance. They would also be likely to seek to divert more weapons purchases to domestic manufacturers. [redacted] 25X1

Smaller or greater welfare cuts than we foresee could make the military budget outlook even bleaker. Failure to hold down deficits by restraining social programs would intensify budgetary pressures on all non-welfare items. Large welfare cuts, on the other hand, would probably fuel popular hostility to existing military spending and make even minor defense increases politically unfeasible. [redacted] 25X1

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Slow growth in military spending will probably delay or eliminate planned equipment modernization programs and may decrease the West European countries' overall military capabilities. Because of high inflation in the defense sector and the growing sophistication of modern weapons, even 3 percent yearly increases in military budgets would probably be insufficient to maintain current forces and fund planned modernization programs. Continued stagnation in West European military spending could force significant cutbacks in military readiness, including personnel reductions, shortened training periods, stretchout of weapons procurement, and cancellation of new weapons purchases. [redacted] 25X1

While welfare cutbacks in Western Europe will probably have little direct economic impact on the United States, failure to restrain soaring welfare budgets could add to pressures for protectionism. Social benefits are financed in large part by employers' contributions, which add considerably to production costs and reduce the competitiveness of West European products in world markets. If welfare-linked wage costs continue to increase and are not offset by other factors such as currency depreciations or gains in productivity, West European firms may demand higher tariffs, quotas, and other non-tariff barriers against competing products from the United States and other countries. [redacted] 25X1

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